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NewsFlash!

HOLY MOSES, BATMAN! THEY'VE STOLEN OUR PRIVATE PLACEMENT EXEMPTIONS!

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The Basic Requirements: Early History

Any sale of a security to a Missouri resident must either be registered with the U.S. Securities and Exchange Commission ("SEC") and the Missouri Securities Commission, or have at least one specific provable exemption from each of those two requirements.

In 1953, the U.S. Supreme Court ruled that the "private offering" exemption of §4(2) of the Securities Act of 1933 (the "1933 Act") required that the issuer prove that all "offerees" (not only purchasers) had sufficient investment sophistication and financial well-being (hereinafter "investment suitability") to establish that they did not "need the protection of registration" under the 1933 Act. SEC v. Ralston Purina, 346 U.S. 119 (1953) But because of the illusory definition of "offerees" as including possibly every person who learned of an offering (not just those receiving an "offer" in the contract sense), the availability and thus the usefulness of the private offering exemption of Section 4(2), was thereafter seriously curtailed.

More Recent History: Viable Exemptions

Federal Regulation D

In 1982, the SEC adopted Regulation D, under which, for federal exemption purposes, the federal restriction to investment-sophisticated persons and to only a small number of such persons were intended to apply only to purchasers. 17 C.F.R. §230.501, et seq. This switch of the applicability of these restrictions from "offerees" to

"purchasers" caused a sea-change increase in the availability of §4(2)'s federal "private offering" exemption.

Missouri's First Apparently Viable Exemptions

In 1956, Missouri adopted the Uniform Securities Act and replaced it in 2003 with the Revised Uniform Securities Act. Both include an exemption for a specific limited number of purchasers per year. (Mo.Rev.Stats. §409.402(b)(10)(1966)(fifteen per year) and §409.202-2(14) (2003)(25 per year), respectively.) These allowed issuers selling to Missouri residents to focus on purchasers rather than "offerees" under Missouri law as well as under federal law. This exemption is commonly called the state "limited offering" (and below sometimes called the "25 per year" exemption.

Federal and State Cooperation: The Regulation D Coordinating and Accredited Investor Exemptions

And more recently, the SEC and the North American Securities Administrators Association ("NASAA") have developed a joint federal and state exemption for use by adopting states to grant exemptions from state registration requirements to issuers who comply with Rules 505 and 506 of Regulation D (hereinafter called the "Reg D Coordinating Exemption"). Missouri's version is set forth in 15 CSR §30-54.210.

Also, the SEC, NASAA and most states have cooperated in the adoption of an "Accredited Investor Exemption." The Accredited Investor Exemption defines "accredited investors" as certain institutions and as persons with net

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worths of at least one million dollars or incomes singly of \$200,000 or jointly with spouse of \$300,000 in the prior two years and the present year. The Missouri Commission adopted the NASAA Accredited Investor Exemption in 2003, replacing a similar exemption it had adopted in 1989. The terms of all of Missouri's 25 per year exemption, its Reg D Coordinating Exemption and its Accredited Investor Exemption require investment suitability of purchasers only. Also, under the terms of the Accredited Investor Exemption, there is no limit on the number of purchasers.

All but the Accredited Investor Exemption prohibit use of "general solicitation" in selling efforts, discussed below.

The Method of Use of These Viable Exemptions

With the adoption of these "purchaser focused" exemptions, securities attorneys around the country developed a fairly consistent method of structuring offerings to meet these requirements. They generally advise their issuer clients to prepare a private placement memorandum, subscription agreement and suitability questionnaire (the latter of which seeks information about the financial status and investment sophistication of persons to be contacted). They then forward these documents to 30-50 (or so) persons (and more when using the Accredited Investors Exemption), together with a letter asking such persons, if they are interested, to review the private placement memorandum, and complete and return the subscription agreement and suitability questionnaire. The issuer may also have small meetings of issuer personnel with 10-12 persons contacted to discuss the investment and to give them the memorandum, subscription agreement and suitability questionnaire.

Then, only after a review of the completed suitability questionnaires, and upon determining that they established that the interested persons held the necessary net worth, income and possibly investment sophistication to be "suitable," the issuer would accept the subscription of

those persons who met the qualifications, and reject those who did not.

The Apparent Destruction of Viable Exemptions in Missouri

But a recent civil prosecution and order by the then-Missouri Securities Commissioner, Douglas Ommen, upheld on appeal by the Court of Appeals for the Western District of Missouri, appears to invalidate this method, and again requires that issuers have reasonable grounds to believe that, prior to contacting any persons, all persons contacted meet the requirements for investment sophistication, net worth and/or accreditation. (This writer was counsel for the unsuccessful respondent/appellant in this case.)

The *Moses* Case in a Nutshell

In his August 2004 Order, In the Matter of John Robert Moses, et al, Case No. CD-03-16, at page 21, Securities Commissioner Ommen ruled that, prior to preliminarily discussing a possible investment with six persons, the issuer must first determine that all such persons are accredited or otherwise qualified. The Commissioner considered all contacts to be "offers" and stated that "before an entrepreneur makes an offer under this [Missouri Accredited Investor] exemption, the law requires that he know the qualifications of the person . . . " contacted, and that discussing the investment with six persons whose qualifications were not previously known constituted unregistered offers, causing the issuer to lose all of the above Missouri exemptions for those offers. (No sales had been made.)

On appeal of Commissioner Ommen's Order, without addressing the wording of Regulation D or its purposes, or the wording or purposes of the Missouri Accredited Investor Exemption, the Reg D Coordinating Exemption or the "25 per year" exemption, the Court of Appeals simply quoted the Commissioner with approval. Moses, et al v. Carnahan, et al, 186 SW3d 889, 908 (Mo.Ct.App. W.D. 2006). And, without citing to the

Moses case, the new Commissioner in a more recent Order (In the Matter of Caobo Company, et al, Case No. AP-06-32 (August 29, 2006) paragraph 12), appeared to require that in similar circumstances, the issuer, prior to solicitation, must have a prior contact or business relationship with the 157 Missouri residents who were solicited and a “reasonable basis. . . for believing that the individuals solicited met the accredited investor definition.”

The effect of the Commissioner’s and the Court’s holdings is to nullify the intended effect of all of these three most useful Missouri exemptions to avoid requiring that all “offerees” be known and believed before initial contact to be suitable as investors.

A main rationale for Commissioner Ommen’s holding was his concern that requiring “vetting” only of purchasers “would permit unlimited offers to any number of persons, so long as the promoter intends to rely on the accredited investor exemption at the time of sale.” (Order, p.20, Conclusion of Law 50). This, of course, is true. But that is how the exemption is intended to work. And arguably inappropriate persons are prevented from investing because only accredited or otherwise suitable persons are allowed to invest. But the Commissioner argued that he needs to be able to enjoin mass solicitations (“offers” in Commissioner Ommen’s view) into Missouri well before any sales are made. This writer, upon exhaustive research, has not found similar reasoning in any other case or authority.

A Deeper Analysis of *Moses*

The Commissioner’s opinion mixes the two concepts of “offer” and “general solicitation” to arrive at this result. Regulation D, and thus Missouri’s exemption coordinating with it, both explicitly prohibit general solicitation. (Regulation D, Rule 502(c).) And Missouri’s “25/year” limited offering exemption also prohibits general solicitation. (Mo.Rev.Stats. §409.2-202(14)(B) (2003).) Regulation D defines “general solicitation” as “including, but not limited to . . . any advertisement . . . in any . . . media.” Virtually all authorities discussing it assume general

solicitation requires solicitation in mass numbers using media such as radio, newspaper, mass mailing lists, telemarketing, etc. But in his opinion in In re Moses, et al, Commissioner Ommen held that a meeting of six persons, who were invited by one-on-one telephone and face-to-face communications, constituted “general solicitation” and an “offer” because the issuer’s president, by

. . . distributing the Note and advising interested persons to come to the [issuer’s] office to invest was in public (i.e., “general”) solicitation. Moses was not acquainted with any of those people who were in attendance. The Commissioner finds that Moses’ comments were made in a presentation format, not in the one-on-one informal manner described by Moses in his testimony While the number of participants [six] may be relevant as to whether the solicitation is public, it is not dispositive.

(Order at p. 18, Conclusion of Law 43. Emphasis added.)

This analysis, or mis-analysis, thankfully did not appear in the Court of Appeals opinion. However, such language may be used again by the Commission (e.g., see In the Matter of Caobo Co., et al, above) or by private plaintiff litigants to establish the presence of “general solicitation” in similar private circumstances.

None of these three Missouri exemptions, by their terms, requires the issuer to have any pre-existing knowledge of persons solicited for interest in investing. Of course, they do require the issuer to fully determine the status and suitability of every purchaser. But Commissioner Ommen’s opinion requires the issuer to determine the financial and investment sophistication status of every “offeree,” and by mixing the “offer” and “general solicitation” concepts, defines an “offeree” to include every person who is contacted by the issuer, directly or indirectly, concerning the sale of securities. If this interpretation is correct, it virtually precludes Missouri (and only Missouri) entrepreneurs from the single greatest advance in-

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NewsFlash!

tended by the SEC and the Commissioners on Uniform State Laws in adopting Regulation D, the “25 per year” exemption and the Reg D Coordinating Exemption, respectively.

And the damage done by the Commissioner’s opinion in Moses does not stop with those exemptions. An even greater advance in raising entrepreneurial capital was the collaboration between the North American Securities Administrators Association (NASAA) and the SEC in creating the Accredited Investor Exemption (adopted by the vast majority of states, and finally adopted in the NASAA format by Missouri in 2003). By its language, this exemption deletes the prohibition on general solicitation if sales are made only to accredited purchasers. The reasoning of then-Commissioner Ommen is tortuous, but it appears to say: “well . . . the language of the exemption just can’t mean what it says.” And the Court of Appeals deferred to and accepted this conclusion. (186 SW3d 889,908)

The Severe Harm to Missouri Entrepreneurs

The three exemptions most available (at least, prior to Moses) to, and the most relied on by, Missouri attorneys for their entrepreneur clients in raising funds from non-institutional investors (i.e., “angels”) are the Missouri Accredited Investor exemption, the Regulation D Coordinating Exemption and the 25 per year limited offering exemption. The Accredited Investor Exemption is undoubtedly the most used. The availability of all these exemptions for sales to Missouri residents by Missouri companies, particularly in comparison to the availability of the virtually identical exemptions in the vast majority of other states, appears to be greatly reduced by Moses.

If the Commissioner and the courts in civil cases continue to accept Commissioner Ommen’s reasoning, Missouri entrepreneurs will be placed at a significant competitive disadvantage with those of the vast majority of other states.

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